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No. 309

IN THE

Supreme Court of the United States

OCTOBER TERM, 1936

S. P. KELLY, Trustee in Bankruptcy for the Carlisle Packing Company, a Corporation, Bankrupt,
Petitioner,

vs.

UNITED STATES OF AMERICA, and the Collector of Internal Revenue for the United States of America, and the Collector of Internal Revenue for the Collection District of Washington,
Respondents.

WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR PETITIONER

W. B. STRATTON,
RALPH O. OLSON,
GEORGE V. WHITTLE, C. P. A.,
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710 Smith Tower,
Seattle, Washington.

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OPINIONS BELOW

Board of Tax Appeals, Opinion (R. 10), is reported in 29 B. T. A. 514.

Special Referee in Bankruptcy, Opinion (R. 90), is not reported.

District Court, Western District, Washington, Opinion (R. 138) is reported in 12 Fed. Supp. 11.

Circuit Court of Appeals, Opinion (R. 158), is reported in 83 Fed. (2d) 783. Opinion on the petition for re-hearing (R. 163), is not reported.

JURISDICTION

The decree of the Circuit Court of Appeals affirming the decision of the District Court was entered on May 5, 1936 (R. 162). Petition for re-hearing was filed June 1, 1936, and order denying same was entered June 29, 1936 (R. 163). The petition for a writ of certiorari was filed on August 24, 1936, and petition granted and writ issued on October 12, 1936. That the jurisdiction of this court is invoked under section 240a of the Judicial Code as amended by the Act of February 13, 1925 (43 Stat. 936) and (U. S. Code, Title 28, Sec. 347). Bankruptcy Act, Sec. 24a and 25 (U. S. Code, Title 11, Secs. 47a and 48).

STATEMENT

Writ of Certiorari was issued by this Court on October 12, 1936, bringing before the Court the decision and decree of June 29, 1936, of the Circuit Court of Appeals for the Ninth Circuit, Hon. Wilbur, Matthews, and Haney Judges thereof, affirming the decision and decree of the United States District Court for the Western District of Washington, of Hon. Edward E. Cushman, Judge thereof, disaffirming the decision of the Special Referee in Bankruptcy, Hon. Tim Healy, and allowing the claim for income taxes of the United States Government.

The substantial and material facts are as follows:

On the 9th day of February, 1934, upon an involuntary petition filed on the 19th day of January, 1934, in the District Court of the United States for the Western District of Washington, Northern Division, an order of adjudication in bankruptcy was

made and filed (R. 2). In this bankruptcy proceeding there was filed on the first day of June, 1934, a statement of claim for taxes due the United States in the sum of $20,515.52, plus interest (R. 3). To this claim for taxes the trustee in bankruptcy in said cause, S. P. Kelly, the petitioner here, filed objections and requested that the claim be rejected (R. 6). These objections came on for hearing before Hon. Tim Healy, special referee in bankruptcy, at Bellingham, Washington (R. 7). The decision of the special referee was rendered December 31st, 1934, disallowing in full the government's claim for taxes (R. 90- 102).

Exceptions to the decision and order disallowing the claim for taxes were duly taken and the petition of the claimant, the United States, for review thereon was filed on the 7th day of January, 1935, with the Clerk of said United States District Court (R. 105-112).

An abstract of the record of the proceedings had before the special referee was brought before said United States District Court, Hon. Edward E. Cushman (R. 7-89), and the order reversing the special referee and allowing the claim for taxes was made, as aforesaid, from which an appeal was taken to the Circuit Court of Appeals, Ninth Circuit (R. 114).

From the abstract of the proceeding had before the special referee, above referred to (R. 7) it appears that the bankrupt, Carlisle Packing Company, is a corporation organized and existing under the laws of the State of Washington, and from the year 1902 had been engaged in the business of salmon fishing and packing, with plants in both Alaska and the State

of Washington. The company had been successfully operated up to and including the year 1919. Thereafter, and for the next five years the petitioner suffered heavy operating losses.

In order to carry on, it started in 1920 to borrow various sums from the Bank of California, National Association (Seattle Branch), and by February 15th, 1927, its indebtedness to that institution was in excess of $1,250,000, evidenced by promissory notes made by petitioner and its President, and sole stockholder, Frank Wright.

Early in 1927 the Bank of California advised Frank Wright, President of the Carlisle Packing Company, that the bank would not finance petitioner during the coming fishing season and demanded that petitioner liquidate its indebtedness to the bank (R. 26). After some negotiations petitioner agreed to and did transfer and convey to the Bank of California its canneries at Cordova and Bristol Bay, Alaska, together with certain equipment, boats, docks, land, etc., all of which is set forth and described in an instrument of transfer which was introduced in evidence (Trustee's Exhibit C., R. 25-57). All of the property was taken over by the Bank of California, for which it agreed to cancel and did cancel $650,000 of petitioner's indebtedness by the cancellation of promissory notes to that amount. This transaction was consummated on February 15th, 1927 (R. 27).

Thereafter the Collector of Internal Revenue for the Collection District of Washington determined the taxable net income for the fiscal years ending November 30th, 1927, 1928 and 1929, and proposed defici-

encies in taxes for those years of the Carlisle Packing Company, and appeals therefrom were filed with the U. S. Board of Tax Appeals by the Carlisle Packing Company in April, 1931, and in April, 1932. Hearings thereon were consolidated before the Board and were heard on September 15th, 1933.

On December 6th, 1933, the Board promulgated its opinion and entered same on January 4th, 1934, wherein it was held that the petitioner realized a taxable profit on the transaction with the Bank of California (R. 10-13).

Thereafter, and on January 12th, 1934, the Commissioner of Internal Revenue made his telegraphic summary assessment (R. 23).

Thereafter, and while the right of appeal from the Board of Tax Appeals still existed, the Carlisle Packing Company was on the 9th day of February, 1934, on involuntary petition adjudicated a bankrupt (R. 2).

The final determination of the Board did not become effective until April 4th, 1934, and under the Revenue Act applicable there to the pendency of a proceeding was in existence at the time of the adjudication.

The taxes for the years 1928 and 1929 are solely based upon the alleged profit from the transaction with the Bank of California in the year 1927, and if there were no such profit on the transaction, then the net loss of 1927 would be allowed under the Revenue Acts to be carried forward to the year 1928 and 1929, thus eliminating any taxable income in those years.

SPECIFICATIONS OF ERROR

Specification of Error No. I.

The Court erred in failing to direct the trial court to correct the omission in the certification with respect to the statement of evidence, by supplemental transcript.

Specification of Error No. II.

The Court erred in refusing to permit and direct the Petitioner to have the trial court correct the omission in certification with respect to the statement of evidence, by supplemental transcript, and to direct that the same be filed in the Circuit Court of Appeals, and to rehear the matter on such properly authenticated record upon the merits of the questions submitted by the parties.

Specification of Error No. III.

The Court erred in indulging the presumption that the evidence supported the judgment and warranted its affirmance, when the merits of the questions were submitted by both parties, and when the record before the Court contained a statement of evidence treated by both of the parties as true and correct.

Specification of Error No. IV.

The Court erred in affirming the decision of the District Court by indulging the presumption that the evidence supports the judgment, and accepting the record as not containing a statement of the evidence, there being no objection to the record on the ground that it was not properly authenticated, both parties having treated the record as containing a statement of the evidence as true and correct, and such state-

ment of evidence being sufficient as to form, and its veracity being unquestioned, and the Court should have directed and permitted the Petitioner to correct the omission in certification by supplemental transcript.

Specification of Error No. V.

The Court erred in affirming the decision of the District Court which held that a decision of the Board of Tax Appeals is *res judicata* and binding upon the Bankruptcy Court.

Specification of Error No. VI.

The Court erred in not holding that the Bankruptcy Court can review the final decision of the Board of Tax Appeals.

Specification of Error No. VII.

The Court erred in affirming the decision of the District Court which had disaffirmed the order of the Special Referee, for the reason that the amount or legality of any income taxes are properly heard and determined by the Court in Bankruptcy, and the Court in Bankruptcy has jurisdiction of all such questions, regardless of the ruling thereon by the Board of Tax Appeals.

Specification of Error No. VIII.

The Court erred in allowing the claim of the United States Government as a priority claim against the estate of said Bankrupt for the reason that said claim is based upon asserted income tax deficiencies during the fiscal years of 1926, 1927, and 1928, when, in fact, there was no taxable income unreported or upon which said bankrupt corporation did not pay income

taxes during the said years and no income tax deficiencies of any nature by said bankrupt corporation during said years.

Specification of Error No. IX.

The Court erred in not finding that the Carlisle Packing Company did not realize a taxable profit upon the transfer of its salmon canning plants, fishing equipment, contracts, leases, fish traps, trap locations, fishing rights and permits, etc., at Cordova, and Bristol Bay, Alaska, to the Bank of California during the fiscal year 1927, for the sum of $650,000.00 paid the Carlisle Packing Company by the satisfaction, cancellation and return of notes in that amount which the Carlisle Packing Company had previously executed and given to the bank for funds in that amount theretofore borrowed.

Specification of Error No. X.

The Court erred in not finding that the Carlisle Packing Company was, in fact, insolvent, at the time of the transfer of the plant, etc., to the Bank of California in satisfaction of its obligation to said bank in the year 1927.

Specification of Error No. XI.

The Court erred in ordering that said claim of the United States be paid for the reasons:

(a) That no sum of money whatsoever is due to the said Government of the United States from the said bankrupt corporation, and

(b) Said order is not supported by the facts out of which the alleged claim of the government arises, and

(c) Is contrary to law.

Specification of Error No. XII.

The Court erred in not ordering that the claim of the Government of the United States against the estate of the said bankrupt corporation be disallowed.

Specification of Error No. XIII.

The Court erred in allowing the claim of the Government of the United States against the estate of the said bankrupt.

Specification of Error No. XIV.

The Court erred in ordering that said claim of the said Government of the United States be paid.

SUMMARY OF ARGUMENT

I. There being no proper certified statement of the evidence before it, the Circuit Court of Appeals should have required the same to be returned to the trial court for proper settlement and authentication; or, if not so required, should have considered all matters before it and decided the case on the merits. The statement of evidence was not properly authenticated as required by equity rule 75b. No objection was made on that account by the respondents and briefs were filed and oral arguments made in the Circuit Court of Appeals without questioning the record. After the cause was thus submitted, the Court, of its own motion without suggestion from or reference to either party, raised the point, and affirmed the decree of the District Court as a penalty for violation of the rule.

It is apparent that the Court thought that the

question of the jurisdiction of the Court to determine the amount and legality of the income tax could not be determined from the record properly before it; and if the Court below was correct in that assumption, then petitioner asserts that he should have been permitted to file a supplemental transcript properly authenticated; that the drastic penalty of affirming the decree of the District Court should not have been imposed; that a failure to properly authenticate the record was an inadvertence and that an opportunity should have been granted to comply with equity rule 75b.

II. The Circuit Court of Appeals for the Ninth Circuit erroneously decided that the Bankruptcy Court was without jurisdiction to hear and determine the amount and legality of a claim for income taxes, section 64(a) of the Bankruptcy Act having given to the Bankruptcy Court complete jurisdiction to determine any question that arises as to the amount or legality of any such tax.

III. The Carlisle Packing Company, a corporation, now in bankruptcy, did not realize in its transaction with the Bank of California, National Association, a taxable income for the year 1927, and the Court was in error in allowing the Government's claim and ordering the same paid as a preference claim.

ARGUMENT

I.

There being no proper certified statement of the evidence before it, the Circuit Court of Appeals should have required the same to be returned to the Trial Court for proper settlement and authentication; or, if not so required, should have considered all matters before it and decided the case on the merits. The statement of evidence was not properly authenticated as required by Equity Rule 75b. No objection was made on that account by the respondents and briefs were filed and oral arguments made in the Circuit Court of Appeals without questioning the record. After the cause was thus submitted, the Court, of its own motion without suggestion from or reference to either party, raised the point, and affirmed the decree of the District Court as a penalty for violation of the rule.

1. The Circuit Court of Appeals should have required petitioner to file a supplemental transcript of record properly authenticated; or, on the record properly before it should have decided the case on the merits.

The jurisdiction of the Bankruptcy Court was challenged and the question was before the Circuit Court on the following record:

(a) The order of adjudication in bankruptcy (R. 2);

(b) The Government's claim for income taxes, the amount of which was fixed by an adjudication of the Board of Tax Appeals and a summary assessment of the Collector of Internal Revenue (R. 3);

(c) The objections to the claim for income taxes, filed by the trustees in bankruptcy proceeding (R. 6);

(d) The decision of the United States District Court, disaffirming the order of the special referee on the ground that the Bankruptcy Court was without jurisdiction (R. 114).

The jurisdiction of the United States District Court as a court in bankruptcy to determine the amount and legality of the claim for income taxes, based on a decision of the Board of Tax Appeals, was the matter presented to this appellate court as a matter of law.

The learned District Judge in his written decision, brought before the Circuit Court as part of the record, made no reference to the evidence, made no findings of fact thereon and based his decision on the sole question of law that—having before it a claim for income taxes based on a decision of the Board of Tax Appeals, the amount and legality of which was drawn in question by objection of the trustee—the matter was beyond the jurisdiction of the Court.

On oral argument petitioner conceded that the only matter before the appellate court for decision was the question of law on a challenge to the Bankruptcy Court's jurisdiction. The petitioner argued and presented only this question of law. The respondents, both in their brief and in oral argument, presented no question except the point of law as to the Bankruptcy Court's jurisdiction. The evidence was not considered or even referred to by either of the parties in oral argument before this Court.

Petitioner respectfully submits that the following

matters were properly before the Circuit Court as part of the record:

(a) Order of adjudication;
(b) Claim for income taxes;
(c) Objection to claim;
(d) Decision of the District Court.

Congress amended Section 269 of the Judicial Code by providing that:

> "On the hearing of any appeal, certiorari, writ of error, or motion for a new trial, in any case, civil or criminal, the court shall give judgment after an examination of the entire record before the court, without regard to technical errors, defects, or exceptions which do not affect the substantial rights of the parties."
>
> U. S. Code, Title 28, sec. 391.

Petitioner contends that under this statute the Court is to examine "the entire record before the Court" and that the above portion of the record, regardless of the statement of the evidence, brought the question of law before the Circuit Court of Appeals.

The Circuit Court of Appeals (Second Circuit) had before it a record on appeal, wherein the clerk of the court below had certified that the transcript is "a correct and complete transcript of the record," but the evidence and the instructions were contained therein with no certificate of authentication by the trial judge.

The Court, considering what was properly before it, after quoting the above statute, said:

> "* * * We are still unable to review the evidence, the charge, and the refusal to charge.

> "The indictment, however, is properly in this court, as it is a part of the record, and needs no bill of exceptions to make it such. And no bill of exceptions is necessary to make the demurrer to the third count a part of the record proper."
>
> *Buessel v. United States*, 258 Fed. 811, 821.

Not having a proper certified statement of the evidence before it, the Circuit Court of Appeals (Seventh Circuit) declared:

> "* * * Not only has appellant violated Rule 9 of this court, but it has failed to secure any approval or certification of the evidence as being all of the evidence received on the trial or necessary to present the case to this court on the merits.
>
> "We have, however, acted on the assumption that all of the evidence is in the record and have overlooked appellant's failure to comply with Rule 9 of this court and have studied the briefs and records with the result that we are entirely satisfied with the decree which was entered."
>
> *Interstate Folding Box Co. v. Empire Box Corporation*, 68 Fed. (2nd) 500.

Petitioner respectfully calls the Court's attention to the fact that the trial judge in no way considered the evidence, nor did he make any findings of fact. The trial court decided as a matter of law on the record before it, without considering the evidence, that the Court was without jurisdiction.

Indeed, the Bankruptcy Court's jurisdiction having been challenged and the Court deciding that it was without jurisdiction to hear the matter, it would not,

and in the circumstances could not, hear the evidence or make any findings of fact thereon.

2. The Circuit Court of Appeals should have required and permitted the petitioner to file a properly certified statement of the evidence by supplemental transcript.

In the alternative, the Court declining to decide the question of law as to the jurisdiction of the Court on the record properly before it, and finding that a statement of the evidence was necessary for a decision on the merits, should have ordered that the omission in certification with respect to the statement of evidence be corrected by a supplemental transcript.

The shaping of the statement of evidence and certification of the same being merely ministerial, sufficiently pertains to the making of the return to the appeal to enable the District Court to authenticate the statement of evidence at any time with the permission of this Court.

Struett v. Hill, 269 Fed. 247.

Having this very question before it, the Court of Appeals for the Ninth Circuit, considered whether or not the record should be returned to the trial court for proper settlement and authentication of a statement on appeal, or whether the appellate court would consider all matters before it and decide the case on the merits, and followed the latter course.

Title & Trust Co, v. Wernich, 69 Fed. (2nd) 811.

In *Sommer v. Rotary Lift Co.* (C. C. A. 9) 66 Fed. (2d) 809, in an equity appeal there was no statement of evidence whatever, yet the court ordered the sub-

mission to be vacated and a supplemental transcript containing a statement of the evidence. This decision was pointed out in the dissenting opinion in the instant case as being in conflict with the decision rendered by the majority of the court.

The Supreme Court of the United States, considering this question in *Barber Asphalt Paving Co. v. Standard Asphalt & Rubber Co.*, 275 U. S. 372, 386, decided that the penalty of dismissal or refusal to decide the case on the merits, where Equity Rule 75 was not followed, was too great and permitted the appellant to have the record conform to the rule:

> "* * * Of course, the practice was in contravention of the equity rule and the court of appeals was right in giving effect to the rule by declining to examine the mass of evidence wrongly reproduced. But the court did not stop there. It also affirmed the decree because of the transgression, and this notwithstanding the transgression was largely due to its own course of action. That was a very severe penalty to impose for action which had the court's implied sanction up to that time. The fact is not overlooked that after the original transcript was filed the appellee called attention to the requirement for condensation and narration and asked that the rule be given effect. But regard also is had for the fact that when the transcript was remitted the district court directed the reproduction of the testimony without condensation or narration.
>
> "When the particular situation in the seventh circuit is considered, we think it is apparent that

> the court of appeals passed the bounds of a sound discretion in affirming the decree, because of the transgression, and that, upon proper terms, it should have remitted the transcript to the district court to the end that a further opportunity might be had to comply with the equity rule. Such a remission should still be made, care being taken to require that the proceedings under the rule be conducted with reasonable dispatch."

Petitioner respectfully calls attention to the fact that the Court in the above decision directed and permitted the transcript to be remitted to the district court and enabled appellant to comply with equity rule, even though objection to the record had been made in the Circuit Court of Appeals. Here in this case no objection has been made to the record and both of the parties have treated the same as true and correct.

In this case, to affirm the ruling of the lower court as a penalty for failure to comply with equity rule, where the same plainly is mere inadvertence, is too severe.

It should be noted that no hearing involving the taking of evidence was had before the Federal judge. The evidence that had been taken before the referee was filed with the clerk of the court on the petition to review.

The hearing on revision before the District Judge was on the transcript of the evidence filed in the clerk's office by the referee. The District Court may be said to have had the evidence before it, but it did not consider the same, made no findings of fact there-

on and based its decision on the question of law raised on the objection to the jurisdiction of the court.

The drastic remedy of affirming the decree as a penalty for violation of the rule should not be applied in this case.

In re General Equity Rule 75, 222 Fed. 884, 886.

This case is to be considered on the whole as a matter in equity and the rights of the parties should be given equitable consideration. The claim for income taxes with interest accrued to date amounts to approximately $25,000.00. A review of the allowance of this large claim is to be denied for inadvertently failing to comply with the equity rule in question. Petitioner did not refuse to comply. And having petitioned the Court at the earliest moment after the matter was brought to his attention, was denied the right to comply with the rule.

Petitioner begs to show to this Court that the evidence in this case is brief, the actual testimony of witnesses covering but ten and one-half pages, the remainder of the statement of evidence consisting entirely of documentary evidence by way of exhibits; that the entire statement of evidence, exhibits included and excluding the record proper, is short, containing less than one hundred pages.

II.

The Circuit Court of Appeals for the Ninth Circuit erroneously decided that the Bankruptcy Court was without jurisdiction to hear and determine the amount and legality of a claim for income taxes, Section 64(a) of the Bankruptcy Act having given to the Bankruptcy Court complete jurisdiction to determine any question that arises as to the amount or legality of any such tax.

1. The Bankruptcy Court has plenary power to hear and determine claims in Bankruptcy proceedings for income taxes.

The contention of the trustee on behalf of the bankrupt is that Section 64a of the Bankruptcy Act gives to the bankruptcy court complete jurisdiction to determine any question that arises as to the amount or legality of any such tax.

Section 64a of the Bankruptcy Act reads as follows:

> "Sec. 64a. The Court shall order the trustee to pay all taxes legally due and owing by the bankrupt to the United States, State, county, district, or municipality, in the order or priority as set forth in paragraph (b) hereof; PROVIDED, That no order shall be made for the payment of a tax assessed against real estate of a bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court. Upon filing the receipts of the proper public officers for such payments the trustee shall be credited with the amounts thereof, *and in case any*

question arises as to the amount or legality of any such tax the same shall be heard and determined by the Court." (Italics ours)

This section was amended May 27th, 1926, but the closing lines of the section have not been changed and still read as they did under the Bankruptcy Act of 1898:

"* * * *and in case any question arises as to the amount or legality of any such tax the same shall be heard and determined by the Court.*"

U. S. Code, Section 104, subdivision a, Title 11, Bankruptcy.

It is most emphatically asserted that the bankruptcy court always did have, and still has, complete jurisdiction to determine the amount or legality of any tax that is claimed to be due from the bankrupt. We contend that there has been no change in this regard by the enactment of the Revenue Law of 1926, nor by any of the revenue enactments since that time. As recent as 1934 the Federal courts have re-announced the position always taken by the bankruptcy courts since the Bankruptcy Act of 1898. That under this Section 64a, above, the amount or legality of any tax shall be heard and determined by the bankruptcy court, and that it is never concluded by any finding or decision of a taxing board, whether State or Federal, nor by any other court.

In construing Section 64a of the Bankruptcy Act, the Supreme Court of the United States declared:

"The Section (64a) itself declares that in case of disputes as to the amount or legality of any such tax, they shall be heard and determined by

the Court. The State Court may construe a statute and define its meaning, but whether its construction creates a tax within the meaning of a federal statute, giving preference to tax, is a federal question, of ultimate decision in this court.

* * * * * * * *

"Coming to the specific objections to the claim for the year 1902, the claim was presented upon the basis of $40,000,000.00 of outstanding capital stock, when in fact there was only $10,000,000.00 of such stock, the assessment by the State Board being upon the former sum and made upon the failure of the corporation to report. But we do not think the finding of the State Board is conclusive. The tax is to be assessed upon capital actually outstanding. It may well be doubted whether the board had power to tax any other stock. But be that as it may, Section 64a, specifically provides that in any case any question arises as to the amount or legality of taxes, the same shall be heard and determined by the Court, with a view to ascertaining the amount really due. We do not think it was the intention of Congress to conclude the Bankruptcy Courts by the findings of Boards of this character, and that the claim should have been upon the basis of the capital stock actually outstanding."

New Jersey v. Anderson, 203 U. S. Rep. 483, 27 Sup. Ct. 137.

It was held in a decision by the Circuit Court of Appeals for the Seventh Circuit that the bankruptcy court is directed by Section 64a of the Bankruptcy Act

to determine independently the "legality of any such tax":

> "But if we are mistaken, and if the *Singer Company* case is to be accepted as an authoritative assertion that the charge in question is a tax, we do not believe that the United States Bankruptcy Courts are bound to follow it blindly. The question with them is the interpretation and application of Section 64a. If the legislature of a state gives the name 'tax' to an exaction which is not a tax, and if the courts of the state join in the misnomer, surely the bankruptcy courts are not required to disregard the substance of the same, to the detriment of other claimants. The state courts may authoritatively expound the substance, and the federal courts will adopt such exposition; but whether the substance constitutes a tax or not is independent of the name. And moreover the latter part of Section 64a seems to direct the bankruptcy court to determine independently the 'legality of any such tax'."
>
> *In re Cosmopolitan Power Company*, 137 Fed. 858, 862.

To the same effect are the following cases:

In re W. P. Williams Oil Co., 265 Fed. 401;
In re Sheinman, 14 Fed. (2d) 323;
In re General Film Corp., 274 Fed. 903;
In re Heffron Co., 216 Fed. 642;
In re Anderson, 275 Fed. 397, aff'd 279 Fed. 525;
In re United Five and Ten Cent Store, 242 Fed. 1005;

In re Heller, Hirsh & Co., 258 Fed. 208;
Commonwealth of Massachusetts v. Meehan, 67 Fed. (2d) 638, 640;
In re Elaborated Ready Roofing Co., 78 Fed. (2d) (C. C. A. 7th) 75.

The government seems to take the position that the rule would be different since the Revenue Act of 1926. However, their contention in this matter is not sustained by the decisions. A decision by the Federal District Court for Massachusetts in the year 1927 declared:

> "The amount of the tax being in dispute, the court is not bound by the determination of the Commissioner (of Internal Revenue). Bankruptcy Act, Section 64a, *New Jersey v. Anderson*, 203 U. S. 483, *In re Fisher Corp.*, 229 Fed. 316."
>
> *In re George F. Redmond & Co.*, 17 Fed. (2d) 128.

The United States Treasury Department, by its regulations, issued under the Revenue Act of 1932, clearly recognizes that the bankruptcy courts have complete jurisdiction regarding the amount and validity of the taxes of a bankrupt.

We quote the following therefrom:

> "Bankruptcy courts have complete jurisdiction under Section 64(a) of the National Bankruptcy Act to determine all disputes regarding the amount and validity of the taxes of a bankrupt."
>
> Regulations 77, "Income Tax," Revenue Act of 1932, Article 1191, p. 313.

That the decision of the Board of Tax Appeals is not binding upon the Bankruptcy Court, is sustained

by General Counsel Memorandum 1 (G. C. M. 1, V-2 CB 92 issued by Honorable A. W. Gregg, General Counsel of the Bureau of Internal Revenue in the following language:

> "Section 282(a)" (which is Section 274(a) 1932 Act heretofore set forth.) "does not seem to provide for a dismissal of a petition filed by a taxpayer with the Board of Tax Appeals for the redetermination of the deficiency, if such petition was filed with the Board prior to the adjudication of bankruptcy of a taxpayer in a bankruptcy proceeding and prior to the immediate assessment provided for in section 282(a). It would therefore seem that in such a case the taxpayer, or the legal representative, might prosecute the petition in the Board of Tax Appeals to final determination before said Board, but whatever might be the final decision of the Board would seem not to be binding upon the bankruptcy court in passing upon any claim for deficiency filed with said court, as provided in section 282(a). This is emphasized by the provisions contained in subdivisions (b) and (c) of Section 282 * * *."

III.

The Carlisle Packing Company, a corporation, now in bankruptcy, did not realize in its transaction with the Bank of California, National Association, a taxable income for the year 1927, and the Court was in error in allowing the government's claim and ordering the same paid as a preference claim.

1. On the transaction with the Bank of California, the Bankrupt reduced or extinguished liabilities without any increase in assets and did not acquire anything of exchangeable value in addition to what it had before.

Did the Carlisle Packing Company realize a taxable income by surrender of all its Alaskan properties to the Bank of California during the fiscal year 1927, for which said bank cancelled $650,000.00 of the packing company's indebtedness for the purpose of avoiding complete liquidation of the Carlisle Packing Company and to enable it to continue business and pay the balance of the creditor's claim?

The bank had no mortgage or priority claim on the properties surrendered to it, and had a balance of a claim for indebtedness after such cancellation of several hundred thousands of dollars, all of which was later paid.

And let us here comment on the case of *Kerbaugh-Empire Co. v. Bowers, Collector of Internal Revenue*, 271 U. S. 170, 46 Sup. Ct. 449, in which case the taxpayer was engaged in the performance of large construction contracts and the borrowed money was lost in the enterprise. The taxpayer made a settlement with its creditor for an amount less than the original

indebtedness, and the court, holding that the difference did not represent taxable income, had this to say:

> "* * * When the loans were made and notes given the assets and liability of the defendant in error were increased alike. The loss of the money borrowed wiped out the increase in assets but the liability remained. The assets were further diminished by payment of the debt. The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit or income."

In the instant case, when it commenced business transactions with the Bank of California, it had a surplus of $1,017,749.22, and on November 30th, 1926, it had only a surplus of $51,208.06, or had lost approximately $1,000,000.00 in operations on the borrowed money from said bank. The loss of the money wiped out any increase in assets, but the liability remained and the assets were further diminished by the payment of the debt.

After the Carlisle Packing Company had surrendered its properties to the bank for the cancellation of $650,000.00 of its notes, it still owed the bank considerable money on principal and interest.

Surely, in the instant case there was nothing "received" or "drawn" by the recipient (taxpayer) for its *separate use, benefit and disposal.*

It is the contention of the trustee that in the instant case there was no taxable income for the year 1927 within the definition of income laid down by the United States Supreme Court in *Eisner v. McComber*, 252 U. S. 189, 40 S. Ct. 199, and which is

the leading case on the question. In this case, and in all subsequent cases on income, the Court relies upon the following definition of "income":

> "* * * Here we have the essential matter; not a gain accruing to capital; not a growth of increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, and coming in, being 'derived'—that is, *received or drawn* by the recipient (the taxpayer) for *his separate use, benefit and disposal*—that is income derived from property. Nothing else answers the description."

The trustee further contends that the Bank of California, in order to benefit the bankrupt to the extent that it could continue in business, forgave and cancelled $650,000.00 of indebtedness for the surrender to it of the Alaska properties of a book value of $345,000.00 and that the difference between those two amounts of approximately $305,000.00 was not taxable income. That this transaction resulted in a reduction of assets with a corresponding reduction in liabilities.

In the case of *Kerbaugh-Empire Co. v. Bowers, Collector of Internal Revenue*, 271 U. S. 170, 46 S. Ct. 449, the court stated in its decision:

> "* * * As has been forcibly stated by counsel for plaintiff, stripped of many of its complications, the situation presented here is about as follows: A. borrowed from B. in 1911 the sum of $1,000.00. A., immediately after borrowing that

sum, lost or spent it. In 1921 A., not having earned anything as the result of personal efforts or use of capital, had in his possession the sum of $100.00. With that $100.00 A. approaches B. and offers him the $100.00, which is all the money he has, if B. will take it as a full settlement of $1,000.00 indebtedness. B. accepts it in full settlement of the indebtedness, and releases A. Has A. any income, within the meaning of the word 'income' as used in the Sixteenth Amendment? If so, where is it, and how or when did he receive it? If A., in the illustration has no income, then clearly this plaintiff had no income in 1921 in the item of $684,456.18, and is entitled to judgment."

We desire to state that the question here involved as to a taxable income on the transaction has been decided adversely to the Government's contention. On this whole question of taxable income trustee relies on a late decision in a parallel case, which was brought before the court on a petition for review of a decision of the Board of Tax Appeals and in reversing that Board's decision, the Court declares:

"* * * Taxable income is not acquired by a transaction which does not result in the taxpayer getting or having anything he did not have before. Gain or profit is essential to the existence of taxable income. A transaction whereby nothing of exchangeable value comes to or is received by a taxpayer does not give rise to or create taxable income. *Commissioner of Internal Revenue v.*

Rail Joint Co., 61 Fed. (2d) 752; *Bowers v. Kerbaugh-Empire Co.* 271 U. S. 170; *Burnett v. John F. Campbell Co.*, 50 Fed. (2d) 487.

"The decision that the petitioner acquired taxable income as a result of the cancellation of its debt to its lessor was erroneous. The petition is granted, and the order under review is reversed."

The Dallas Transfer Etc. Co. v. Com'r. of Internal Revenue, 70 Fed. (2d) 95.

In the foregoing cited case the taxpayer was in no condition to pay the indebtedness and was insolvent. In the case at bar the evidence shows that the bankrupt was in no condition to pay its indebtedness and was insolvent. In the case cited above the taxpayer at the time it surrendered certain of its property to its creditor for release of indebtedness, was insolvent. In the case at bar the bankrupt at the time it surrendered certain of its property to its creditor for release of indebtedness, was insolvent. In the case at bar the taxpayer surrendered property, the basis of value of which was considerably less than the indebtedness released therefor. In the case cited above the taxpayer surrendered property, the basis of value of which was conisderably less than the indebtedness released. In the case cited above, if suit had been brought it would have resulted in putting petitioner out of business. In the case at bar, if suit had been brought it would have resulted in putting the bankrupt out of business.

In both cases there was a reduction or extinguishment of liabilities without any increase in assets and neither of the cases resulted in the debtors acquiring

something of exchangeable value in addition to what they had before.

In the instant case there is an absence of such a gain or profit as is required to come within the accepted definition of income.

The trustee contends, notwithstanding claimant's assertions to the contrary, that at no time has he abandoned the "theory" that the bankrupt corporation was insolvent at the time of the surrender of its properties to the Bank of California. The evidence produced at the hearing deals specifically with this question and also shows that the corporation paid off its debts for less than the amount borrowed.

Furthermore, these two points have been consistently contended by taxpayer at all times since the determination of the deficiency by the Commissioner.

CONCLUSION

In conclusion, we respectfully submit that this cause should be heard and decided on the merits. It is to the interest of both parties to have a decision on an important question of law touching the jurisdiction of the bankruptcy court.

Petitioner urges that the question of jurisdiction was raised on the record properly before the Circuit Court of Appeals, without consideration of the statement of evidence. The District Court, sitting in bankruptcy, with a claim filed for income taxes based on a decision of the Board of Tax Appeals and the Internal Revenue Collector's summary assessment, to

which claim the trustee objected, decided that it was without jurisdiction. The District Court decided, as a matter of law on the record, and not on the evidence, that the decision of the Board of Tax Appeals was *res judicata* as to the amount and validity of the claimed indebtedness for income taxes.

In the alternative, in the event that the Court deems it necessary to a decision on the merits, the record should be remitted for proper certification with respect to the statement of evidence by a supplemental transcript. Equity Rule 75b, by inadvertence, was not complied with. We call attention to the fact that the evidence having been filed with the Clerk of the Court by the referee, and not having been introduced as on a trial before the judge, it was inadvertently treated as part of the record. Both parties have treated it as a statement of evidence as true and correct. Although improperly authenticated, the respondents did not object to it. The cause was submitted on briefs and oral argument, without hint or suggestion that the record was improperly authenticated.

The practice did not comply with the equity rule, and we could make no complaint had the Court required a compliance.

But, affirming the decree of the District Court, because of the transgression, is going much farther; and is exacting an enormous penalty for failure to comply with the rule.

We respectfully submit that in equity and justice this severe penalty should not be exacted. A claim, with interest, totaling approximately $25,000.00, is to

be ordered paid over objection without a hearing on the merits.

Petitioner contends that Section 64(a) of the Bankruptcy Act gives the bankruptcy court jurisdiction in any circumstances to determine the amount and legality of the claim for income taxes.

Petitioner contends that after the decision of the Board of Tax Appeals, the taxpayer having been adjudicated a bankrupt, and a claim for income taxes based on the Board's decision is filed in the bankruptcy proceedings, and such claim being questioned, the amount and legality of such claim may thereupon be determined by the bankruptcy court.

We submit that the bankruptcy court is still clothed, as it always has been, with plenary power to determine the amount and legality of every claim for taxes, including a claim based on a decision of the Board of Tax Appeals. That to take away such power by implication, as respondents must claim by virtue of the Revenue Act, would mean that a statute of the United States establishing a court and defining its jurisdiction could thus be modified or amended, and that such court could no longer carry out its primary function to administer a fair and equitable distribution of the bankrupt's estate to all the creditors.

The rule laid down in *New Jersey v. Anderson*, 203 U. S. 486, declares the law that should govern this case, and the decision of the lower courts are clearly in conflict with the same.

And finally it is submitted that there was no taxable income realized by the Carlisle Packing Company in its transaction with the Bank of California, Na-

tional Association, and that the lower courts should have heard and determined this question, and now this court should determine and decide that there was no taxable income realized.

The rule as to taxable income set forth in *Eisner v. McComber*, 252 U. S. 189, 40 S. Ct. 199, and *The Dallas Transfer Etc. Co. v. Com'r. of Internal Revenue*, 70 Fed. (2d) 95, is the rule and the law that governs the situation here, and the decisions of the lower courts are at variance therewith.

We respectfully submit that the decision of the Court below should be reversed.

Respectfully submitted,

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